

Message Text

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ACTION ARA-14

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TO SECSTATE WASHDC 5862
INFO AMEMBASSY BRASILIA
AMCONSUL SAO PAULO

LIMITED OFFICIAL USE SECTION 1 OF 2 RIO DE JANEIRO 0798

SAO PAULO FOR COMMERCIAL COUNSELOR

E.O. 11652: N/A
TAGS : EGEN EINV BR
SUBJECT : FORMER FINANCE MINISTER DISCUSSES MAJOR ISSUES
FACING BRAZIL

1. BEGIN SUMMARY: RIO CONSUL GENERAL AND E/C SECTION CHIEF
MET WITH OCTAVIO GOUVEIA DE BULHOES, FORMER FINMIN AND HIGHLY-
REGARDED OBSERVER OF BRAZILIAN ECONOMIC SCENE, ON FEBRUARY 16.
EXTENDED CONVERSATION COVERED GENERAL OUTLOOK (INCLUDING
EXPRESSION OF CONFIDENCE THAT ANTI-INFLATION PROGRAM IS
WORKING), BUT ALSO INCLUDED BULHOES'S DETAILED ANALYSES OF
SEVERAL IMPORTANT ISSUES: MEASURES TO ENCOURAGE CONVERSION OF
FOREIGN FIRMS' INTRACOMPANY DEBT INTO EQUITY; THE ALCOHOL
PROGRAM; CURRENT COMMUNICATIONS MINISTRY EFFORT TO FORCE
DOMESTIC SUPPLIERS TO NATIONALIZE THEIR CAPITAL; AND THE IM-
PORT/TRAVEL PRIOR DEPOSITS POLICY. END SUMMARY.

2. FORMER MINISTER BULHOES AT 72 REMAINS BOTH INFLUENTIAL AND
ACTIVE, INCLUDING SERVING AS CHAIRMAN OF THE BOARD OF MERCEDES-
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BENZ DO BRASIL AND HOLDING SEVERAL DIRECTOR'S SEATS ON OTHER
BOARDS. HE IS, OF COURSE, ALSO A MEMBER OF THE GOB'S MONETARY
COUNCIL (CNM). IN AN HOUR'S CHAT WITH CONSUL GENERAL DEXTER
AND E/C CHIEF, HE GAVE A THOROUGH OVERVIEW OF THE ECONOMIC
SITUATION -- AT TIMES, CRITICAL OF SPECIFIC POLICIES AND TRENDS,
BUT GENERALLY SUPPORTING THE GOB APPROACH TO ITS BASIC TRADE
AND INFLATION CONCERNS.

3. BULHOES SAW 1977 PERFORMANCE AS REASONABLY GOOD THOUGH THE INFLATION RATE WAS STILL INTOLERABLY HIGH. THE SMALL (7 PERCENT) DROP IN 1977 INFLATION FROM 1976, WHICH REPRESENTED EARLY RESULTS FROM THE ADMINISTRATION'S BELATED COMMITMENT TO CONTROL PRICES, WOULD NOT BE ADEQUATE THIS YEAR. HE BELIEVES THAT A GOAL OF 2 PERCENT INFLATION PER MONTH WOULD BE REASONABLE BUT DOESN'T PREDICT THAT IT WILL BE OBTAINED. HE OBSERVED THAT FIRST-HALF RESULTS LAST YEAR WERE MAINLY TO BLAME FOR THE WHOLE-YEAR OUTCOME, SINCE THE ABOUT-25 PERCENT (ANNUAL RATE) SECOND HALF HAD BEEN QUITE GOOD. HE BELIEVED 1978 WOULD SEE A SIMILAR DIFFERENCE BETWEEN SEMESTERS: A SO-SO FIRST SIX MONTHS AND A GOOD SECOND HALF.

4. ASKED HOW MUCH OF BOTH YEARS' PERFORMANCE HAD BEEN DUE TO FISCAL AND HOW MUCH TO MONETARY MEASURES, HE INDICATED THAT NO ONE COULD REALLY KNOW. BUDGET CUTS FOR MAJOR INVESTMENT PROGRAMS HAD CERTAINLY PLAYED A SIGNIFICANT ROLE, BUT CAREFUL MANAGING OF MONETARY AGGREGATES HAD BEEN EFFECTIVE IN RESTRAINING DEMAND. "WITHIN THE NEXT TWO MONTHS," IT SHOULD BE POSSIBLE TO PREDICT 1978 TRENDS IN INFLATION; THE SEASONAL LIQUIDITY EXERCISE IN THE PAST TWO MONTHS WAS COMPLICATED BY THE FREEZE ON CRUZEIRO DRAWDOWNS OF FOREIGN BORROWING, MAKING CURRENT RESULTS USELESS IN UNDERSTANDING THE TREND. (PRESS REPORTS INDICATE THAT M1 DECLINED ONLY 6.4 PERCENT IN JANUARY -- VERSUS 8.6 PERCENT A YEAR AGO -- DUE TO DRAWDOWNS AGAINST \$1.7 BILLION LIMITED OFFICIAL USE

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IN FOREIGN LINDING.) IT REMAINS UTTERLY NECESSARY TO RESTRAIN GROWTH ("SINCE IT HAS NOT AFFECTED EMPLOYMENT") FOR THE NEXT TWO YEARS OR LONGER TO REDUCE INFLATION TO MANAGEABLE LEVELS IN THE 10-15 PERCENT RANGE.

5. BULHOES MENTIONED THE PROPOSAL, FIRST HEARD LAST OCTOBER, TO GIVE A TAX BREAK TO FOREIGN-OWNED FIRMS WHO CONVERTED LOANS FROM THEIR PARENT COMPANIES INTO EQUITY. THIS COULD REDUCE BRAZIL'S FOREIGN DEBT BY SEVERAL BILLION DOLLARS. FIRMS HAD USED LOANS INSTEAD OF EQUITY AS A SIMPLE PRECAUTION, AGAINST POSSIBLE RESTRICTION ON REMITTANCE OF DIVIDENDS, BUT NOW MIGHT BE WILLING TO CONVERT THEM IF IT WERE MADE ATTRACTIVE IN TERMS OF TAX TREATMENT OF THE ADDITIONAL DIVIDENDS. ASKED ABOUT PUBLIC CRITICISM THAT SUCH INCENTIVES AMOUNTED TO A "GIFT TO THE MULTINATIONALS," BULHOES SAID SUCH COMPLAINTS WERE OF LITTLE REAL CONCERN. THE REAL DIFFICULTY IS THE CONFLICT OF DOUBLE-TAXATION TREATMENT, PARTICULARLY VIS-A-VIS THE US; THE GOB WAS UNCERTAIN WHETHER REMITTANCES NOT TAXED HERE WOULD SIMPLY BE TAXED EQUALLY ON THE OTHER END. HE SAID THIS WAS NOT THE CASE FOR WEST GERMANY AND JAPAN, BUT THE US LAW PROBABLY MEANT THAT ANY BRAZILIAN PROGRAM WOULD BE FRUSTRATED.

6. SPEAKING ABOUT FOREIGN INVESTMENT, BULHOES SAID HE WAS TROUBLED BY AN "INCONSISTENCY" IN BRAZIL'S EFFORTS TO PROMOTE FOREIGN INVESTMENT. THE COMMUNICATIONS MINISTRY IS, HE SAID, NOW PUSHING TO GET ALL DOMESTIC SUPPLIERS TO TELEBRAS AND ITS SUBSIDIARIES TO BE 100 PERCENT BRAZILIAN-OWNED; THIS IS DIAMETRICALLY OPPOSED TO THE POLICY OF THE FINANCE MINISTRY, WELCOMING FOREIGN INVESTMENT. WE SAID WE HAD HEARD OF THE PROBLEM PARTICULARLY IN SAO PAULO, AND WONDERED TO WHAT DEGREE IT WAS GOB POLICY TO FORCE SUCH NATIONALIZATION. HE SAID IT WAS NOT GOB POLICY, JUST THAT OF THE SINGLE MINISTRY WHICH HAD LAUNCHED THE CRUSADE. HE SAID THE "INCONSISTENCY" DOES NOT AFFECT PURCHASING POLICY IN ANY OTHER SECTOR -- BUT ACKNOWLEDGED THAT IT WAS BOUND TO CAUSE CONFUSION AMONG INVESTORS. LIMITED OFFICIAL USE

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(COMMENT: HE WAS NOT APOLOGETIC ABOUT THE PROBLEM, DID NOT COMMENT ABOUT THE INTRA-GOB WRANGLING IT IS EVIDENTLY CAUSING, BUT IS CLEARLY DISMAYED ABOUT THE EFFECT SUCH GOB DISARRAY MUST BE PRODUCING. ALTHOUGH WE HAVE SEEN THE EFFECTS OF THE CHANGE ONLY IN CONNECTION WITH SMALLER SUPPLIERS, PRESUMABLY HIS STATEMENT THAT IT WILL AFFECT "ALL" TELECOMMUNICATIONS SUPPLIERS MEANS THAT LARGE FIRMS SUCH AS ITT-STANDARD ELECTRIC AND ERICSSON WILL ALSO LOSE CONTRACTS WITH THE STATE TELEPHONE COMPANIES. END COMMENT.)

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INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-08 FRB-03

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SAO PAULO FOR COMMERCIAL COUNSELOR

7. TURNING TO RECENT PUBLICITY ON A RE-EMPHASIS OF AGRICULTURAL DEVELOPMENT, HE SUPPORTED SUCH EMPHASIS, ESPECIALLY SINCE THE NEXT PHASE OF EXPORT DEVELOPMENT MUST RELY ON INCREASED OUTPUT OF AGRICULTURAL GOODS. EVEN ON THE DOMESTIC SIDE, MEDIUM-TERM INFLATION CONTROL REQUIRES UPGRADING OF FOOD OUTPUT. HE DESCRIBED THE MOVEMENT OF LARGE INDUSTRIAL FIRMS INTO AGRI-BUSINESS HERE, WHICH WILL ENCOUNTER OPPOSITON BUT PREDICTED THAT SUCH INVOLVEMENT WOULD BE GOOD FOR GENERAL DEVELOPMENT -- PARTICULARLY IN SLOWING MIGRATION TO THE CITIES AND SPREADING THE BENEFITS OF BRAZIL'S ECONOMIC DEVELOPMENT. HE WAS IN FAVOR OF ADDITIONAL SUPPORT FOR AGRICULTURE, BUT ADAMANT THAT GOVERNMENT MANAGEMENT OF THE RURAL ECONOMY MUST BE AVOIDED.

8. BULHOES SEES THE ALCOHOL PROGRAM AS A POTENTIALLY IMPORTANT FACTOR IN FUTURE AGRICULTURAL DEVELOPMENT. ALTHOUGH NOTING THAT IT WILL BE SOME TIME BEFORE THE PROGRAM'S ECONOMIC VIABILITY IS ESTABLISHED, HE SEEMED OPTIMISTIC THAT ALCOHOL WILL EVENTUALLY BECOME COMPETITIVE WITH GASOLINE AS A MOTOR LIMITED OFFICIAL USE

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FUEL. HE ACKNOWLEDGED THAT THIS IS NOT PRESENTLY THE CASE, WITH ALCOHOL COSTING 8-10 CRUZEIROS FOR THE MILEAGE EQUIVALENT OF A LITER OF GASOLINE THAT COSTS ABOUT 7 CRUZEIROS, BUT NOTED THAT ALCOHOL COSTS MAY BE REDUCED BY USE OF MANIOC IN PLACE OF CANE AS THE RAW MATERIAL, AND BY INCREASING PER HECTARE PRODUCTIVITY OF MANIOC; GASOLINE PRICES, ON THE OTHER HAND, ARE MORE LIKELY TO RISE THAN TO DECLINE.

9. BRIEFLY DISCUSSING THE TRADE SITUATION, BULHOES SAID THERE WAS SERIOUS CONCERN ABOUT THE CONTINUING IMPACT OF BARRIERS TO IMPORTS. INDUSTRIAL PLANTS WERE NOW BEING CONSTRUCTED HERE WITH EQUIPMENT COSTS DOUBLE OR TRIPLE WHAT THEY HAD BEEN SEVERAL YEARS AGO -- AND THIS WAS MAINLY DUE TO HIGH TARIFFS AND PRIOR DEPOSITS. (HIGH INTEREST COSTS WERE ALSO A FACTOR, BUT BULHOES DID NOT SEE ANY SHORT-TERM WAY TO INCREASE EQUITY FUNDING OF INDUSTRIAL PROJECTS.) THIS MEANT THAT THERE WERE SERIOUS SHORTFALLS IN CAPACITY, PARTICULARLY IN CONSUMER GOODS. HE NOTED, AS AN EXAMPLE, BRAHMA BREWERY (ON WHOSE BOARD HE HAS A SEAT), WHICH KNOWS IT MUST INSTALL CONSIDERABLE NEW CAPACITY TO MEET CURRENT DEMAND -- BUT CANNOT, SINCE THE BEER PRODUCED AT PRESENT HIGH CAPITAL COSTS WOULD HAVE TO BE PRICED CONSIDERABLY HIGHER THAN PRESENT OUTPUT.

10. BULHOES SAID UNDER SUCH CIRCUMSTANCES MANY INVESTMENT

DECISIONS ARE BEING POSTPONED, AND THERE WILL BE SUBSTANTIAL INFLATIONARY PRESSURES FROM THE SCARCITY OF GOODS IN THE NEXT SEVERAL YEARS. THE SOLUTION IS DIFFICULT TO PRESCRIBE, HE SAID, SINCE CAPITAL GOODS PRODUCERS WILL DOUBTLESS OPPOSE TRADE LIBERALIZATION. HE FEELS, NONETHELESS, THAT THE GOVERNMENT WILL EVENTUALLY ABANDON THE PRIOR DEPOSIT ON IMPORTS; ANY THREAT TO THE MONEY SUPPLY BY RELEASE OF THE ACCUMULATED FUNDS CAN BE HANDLED, HE SAID, BY PHASING THE PAYOUTS OVER (POSSIBLY) A 2-YEAR PERIOD. ASKED WHEN SUCH A CHANGE MIGHT LIMITED OFFICIAL USE

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BE MADE, HE CRYPTICALLY STATED THAT "THE FINANCE MINISTER COULD LOGICALLY DROP BOTH IMPORT AND TRAVEL DEPOSITS AT THE END OF THE YEAR, TO GIVE A CLEAN SLATE TO HIS SUCCESSOR." BULHOES COULD NOT PREDICT THE LIKELIHOOD OF THIS SCENARIO. (COMMENT: HIS STATEMENT SEEMS ALSO TO IMPLY THAT BULHOES EXPECTS SIMONSEN TO LEAVE THE FINANCE MINISTER POSITION AT THE END OF THE GEISEL ADMINISTRATION. END COMMENT.)

11. SPEAKING FURTHER OF FOREIGN TRADE, BULHOES EXPRESSED OPTIMISM ABOUT EXPORT PROSPECTS FOR 1978 BUT COMMENTED ON THE INHIBITING EFFECT OF BRAZIL'S SYSTEM OF MINI-DEVALUATIONS. AS THE SYSTEM IS APPLIED, HE SAID, DEVALUATION TENDS TO RUN BEHIND THE INFLATION RATE, THUS KEEPING BRAZIL'S EXPORTS OVERPRICED. HE DOES NOT EXPECT THIS LAG TO BE CORRECTED, HOWEVER, BECAUSE OF THE EFFECT LARGER DEVALUATIONS WOULD HAVE ON FOREIGN DEBT AND BECAUSE OF THE HARMFUL COSMETIC EFFECT OF HIGHER RATES OF ADJUSTMENTS, ON THE ORDER, SAY, OF 2 PERCENT PER MONTH. (COMMENT: RECENT MINI-DEVALUATIONS HAVE BEEN AS HIGH AS 3.4 PERCENT FOR 21-DAY PERIOD (MARCH 9-30, 1976) AND TOPPED 2 PERCENT FIVE TIMES IN 1977.) DEXTER

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